

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of

Accounting for Judgments and
Other Costs Associated with
Litigation

CC Docket No. 93-240

REPORT AND ORDER

Adopted: March 11, 1997

Released: March 13, 1997

By the Commission:

TABLE OF CONTENTS

	Paragraph
I. INTRODUCTION	1
II. BACKGROUND	2-14
A. Ratemaking	3-5
B. Accounting Requirements	6-8
C. Litigation Costs	9-14
III. CURRENT PROPOSAL	15
IV. COMMENTS	16
V. DISCUSSION	17-60
A. Need for Rule Change	17-21
B. Adverse Antitrust Judgments	22-29
C. Settlements	30-47
D. Litigation Defense Costs	48-52
E. Other Types of Litigation	53-57
F. Interim Action	58-60
VI. FINAL REGULATORY FLEXIBILITY ANALYSIS	61-64
VII. ORDERING CLAUSES	65-70

APPENDIX - Amendment of Part 32 of the Commission's Rules

I. INTRODUCTION

1. In this proceeding, we consider the Commission's accounting rules and ratemaking policies that should apply to litigation costs incurred by carriers subject to the Commission's Part 32 rules.¹ The Commission had previously adopted rules and policies to govern the Commission's accounting treatment of litigation costs arising from lawsuits alleging the violation of antitrust and other federal laws.² That decision was reversed and remanded by the United States Court of Appeals for the District of Columbia Circuit on the grounds that the Commission had neither adequately justified the application of its rules and policies to costs arising in lawsuits other than antitrust litigation nor sufficiently analyzed the effects of its rules and policies on carriers' litigative behavior.³ The court also found that the Commission had failed to explain why its change in the treatment of litigation costs did not constitute retroactive ratemaking.⁴ Based upon the record in this proceeding and changes to the Commission's ratemaking policies occurring since the Commission initially considered these accounting issues, we conclude that there should be special rules to govern the accounting treatment of federal antitrust judgments and settlements, in excess of the avoided costs of litigation, but not for litigation expenses. We further conclude that these special rules should not apply to costs arising in other kinds of litigation.

II. BACKGROUND

2. A fundamental requirement of Title II of the Communications Act of 1934, as amended, is that "all charges . . . for and in connection with [interstate] communication service, shall be just and reasonable."⁵ This provision safeguards consumers against rates that are unreasonably high and guarantees carriers that they will not be required to charge rates that are

¹ 47 C.F.R. § 32.7370.

² Notice of Proposed Rule Making to Amend Part 31 Uniform System of Accounts for Class A and Class B Telephone Carriers to Account for Judgments and Other Costs Associated with Antitrust Lawsuits, and Conforming Amendments to the Annual Report Form M, CC Docket No. 85-64, *Notice of Proposed Rulemaking*, FCC 85-120 (released May 3, 1985) (*Litigation Costs NPRM*); *Report and Order*, 2 FCC Rcd 3241 (1987) (*Litigation Costs Order*); *recon. in part*, 4 FCC Rcd 4092 (1989) (*Litigation Costs Recon. Order*) (collectively, *Litigation Costs Proceeding*), *vacated and remanded sub nom. Mountain States Tel. and Tel. Co. v. FCC*, 939 F.2d 1035 (D.C. Cir. 1991) (*Litigation Costs Decision*).

³ *Litigation Costs Decision*, 939 F.2d at 1042.

⁴ *Id.* at 1044.

⁵ 47 U.S.C. § 201(b).

so low as to be confiscatory.⁶ Carriers under the Commission's jurisdiction must be allowed to recover the reasonable costs of providing service to ratepayers, including reasonable and prudent expenses and a fair return on investment. This fundamental requirement is unchanged by the Telecommunications Act of 1996.⁷

A. Ratemaking

3. The method for achieving just and reasonable rates has evolved over the years. Under traditional rate-of-return regulation still applied to most of the smaller incumbent local exchange carriers (ILECs), carriers set rates to recover their revenue requirements, which consist of allowable expenses and taxes plus a reasonable return on capital investment devoted to or "used and useful" in providing the utility service.⁸ In 1989 for AT&T⁹ and 1990 for the largest ILECs, the Commission adopted a different approach, commonly called incentive or "price cap" regulation, to give carriers pricing flexibility within limits designed to protect customers from unreasonably high rates and discriminatory pricing practices.¹⁰ The Commission's intent with price cap regulation is to create efficiency incentives like those found in competitive markets until actual competition makes price cap regulation unnecessary.

4. Limits are placed on the rates ILECs subject to price cap regulation may charge for regulated services. A carrier's services are grouped together in "baskets" on the basis of common characteristics, and the weighted prices in each group are adjusted annually pursuant to a formula applied to the benchmark price cap index. Although the Commission's goal is "pure" price cap regulation, the Commission has retained features of rate-of-return regulation for incumbent local exchange carriers by adding a backstop to the ILECs' productivity predictions. This backstop leads to rate adjustments whenever it appears that rates may fall outside the zone of

⁶ See, e.g., *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944). The "just and reasonable" standard coincides with the constitutional standard derived from the due process and taking clauses of the Fifth Amendment. See *FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942).

⁷ Telecommunications Act of 1996, Pub. L. 104-104, 110 Stat. 56 (1996) (*1996 Act*). In this Report and Order, we refer to provisions of the *1996 Act* using the sections at which they will be codified.

⁸ For a discussion of the history of carrier rate regulation, see generally Policy and Rules Concerning Rates for Dominant Carriers, CC Docket 87-313, *Report and Order and Second Further Notice of Proposed Rulemaking*, 4 FCC Rcd 2873, 2882-2893 (1989). See also Separation of costs of regulated telephone service from costs of nonregulated activities, CC Docket 86-111, *Report and Order*, 2 FCC Rcd 1298, 1299-1303 (*Joint Cost Order*), modified on recon., 2 FCC Rcd 6283 (1987) (*Joint Costs Recon. Order*); *aff'd sub nom. National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

⁹ But see Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, *Order*, 11 FCC Rcd 3271 (1995). AT&T has not been subject to price cap regulation since it was declared non-dominant.

¹⁰ See *LEC Price Cap Order*, 5 FCC Rcd at 6811.

reasonableness for tariff review purposes.¹¹ ILECs for which interstate earnings in a calendar year exceed a specified return must share with ratepayers part or all of the earnings above that benchmark; those with earnings below a specified return may raise their price cap indices at the next annual tariff filing (the "low-end adjustment"). Price cap regulation is mandatory for the seven regional Bell operating companies and GTE.¹² It is optional for other ILECs, although several have chosen it.¹³

5. The Commission has adjusted the ILEC price cap plan on several occasions in response to court decisions and to changes in technology, regulation, and the market.¹⁴ In its first comprehensive review of price cap performance for ILECs, the Commission specified three productivity factors from which price cap carriers could choose. Carriers selecting the highest factor and, therefore, increasing their price cap indices the least, will no longer have sharing obligations and will not be permitted to make low-end adjustments.¹⁵ Carriers selecting the smaller productivity factors will continue to be subject to sharing. The Commission currently is reviewing the way it sets the productivity factor used in the price cap formula, the need to retain sharing in a plan with multiple productivity factors, and the efficacy of possible alternatives to sharing.¹⁶ The Commission has also proposed a framework that could adapt ILEC price cap regulation to the emergence of competition for local exchange and exchange access services and eventually eliminate price cap regulation for interstate access services subject to substantial

¹¹ See generally *LEC Price Cap Order*, 5 FCC Rcd 6786, *LEC Price Cap Reconsideration Order*, 6 FCC Rcd 2637; *Price Cap Performance Review for Local Exchange Carriers, First Report and Order*, 10 FCC Rcd 8961, 8975, ¶ 32 (1995) (*LEC Performance Review*).

¹² *LEC Price Cap Order*, 5 FCC Rcd at 6818-19.

¹³ Alliant Communications Co., Frontier Corporation, Southern New England Telephone Company, Sprint Local Telephone Companies and Citizens Telecommunications Companies have all voluntarily chosen to be subject to price cap regulation.

¹⁴ See generally *LEC Performance Review*, 10 FCC Rcd at 8976-8978, ¶¶ 34-36 (adjustments summarized).

¹⁵ *Id.* at 9050, ¶¶ 199-200. Some carriers have chosen the highest productivity factor. See Annual 1995 Access Tariff Filings, United and Central Telephone Companies Petition Regarding Election of 5.3 X-Factor for Application Back to January 1, 1995, *Memorandum Opinion and Order*, 10 FCC Rcd 12643 (Com. Car. Bur. 1995); Annual 1995 Access Tariff Filings, Ameritech Petition Regarding Election of 5.3 X-Factor for Application Back to January 1, 1995, *Memorandum Opinion and Order*, 10 FCC Rcd 12289 (Com. Car. Bur. 1995); Annual 1995 Access Tariff Filings, Pacific Bell and Nevada Bell Petition Regarding Election of 5.3 X-Factor for Application Back to January 1, 1995, *Memorandum Opinion and Order*, 10 FCC Rcd 12301 (Com. Car. Bur. 1995); Annual 1995 Access Tariff Filings, Petitions Regarding Election of 5.3 X-Factor for Application Back to January 1, 1995, *Memorandum Opinion and Order*, 10 FCC Rcd 9874 (Com. Car. Bur. 1995) (Rochester Telephone Corp. and Frontier Communications of Iowa, Inc. and Frontier Communications of Minnesota, Inc., and Lincoln Telephone and Telegraph Company).

¹⁶ *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, *Fourth Further Notice of Proposed Rulemaking*, 10 FCC Rcd 13659, at ¶¶ 112-29 (rel. Sept. 27, 1995) (*X-Factor NPRM*).

competition.¹⁷ Under the Telecommunications Act of 1996, streamlined tariff filing process will become effective in February 1997, but the price cap structure remains unchanged.¹⁸

B. Accounting Requirements

6. Accurate identification of costs is central to the Commission's ability to carry out its responsibilities. The cost information that provides the basic data from which a carrier's rates are computed and evaluated under the just and reasonable standard is retained in accounts prescribed by the Commission's rules.¹⁹ The Commission is authorized under Section 220(a)(1) of the Communications Act of 1934, as amended, to prescribe the forms of accounts to be kept by carriers subject to its jurisdiction and by subsection (a)(2) to prescribe by rule a uniform system of accounts for use by all telephone companies, "which shall ensure a proper allocation of all costs to and among telecommunications services, facilities, and products . . . which are developed, manufactured, or offered by such common carrier."²⁰ The accounting classification does not conclusively determine whether a particular expenditure will be allowed or disallowed for ratemaking purposes, but it does create presumptions that affect the ratemaking treatment of the expense for ILECs subject to rate-of-return regulation or sharing obligations under price cap regulation. Accounting for an expense "above the line" creates the rebuttable presumption that the expense will be allowed in the revenue requirement and will become the responsibility of ratepayers.²¹ Conversely, accounting below the line creates the rebuttable presumption that the expense will be disallowed in a rate case, making it the responsibility of the shareholders.

7. The larger ILECs, the Class A telephone companies, periodically report to the Commission the information collected in the USOA, and that information is placed in the Commission's Automated Reporting Management Information System (ARMIS) used to monitor carrier investment and expenses and administer the Commission's accounting, separations, joint

¹⁷ Price Cap Performance Review for Local Exchange Carriers, *Second Further Notice of Proposed Rulemaking*, 11 FCC Rcd 858, 918-924 (Sept. 20, 1995) (*LEC Pricing Flexibility NPRM*).

¹⁸ Sec. 204(a)(3) of the Communications Act, 47 U.S.C. § 204(a)(3). Tariffs will be presumed lawful and become effective on 7 or 15 days notice unless the Commission takes action during the notice period. See Implementation of Section 402(b)(1)(A) of the Telecommunications Act of 1996, *Notice of Proposed Rulemaking*, 11 FCC Rcd 14696 (1996).

¹⁹ See 47 C.F.R. Part 32.

²⁰ 47 U.S.C. § 220(a)(1), (2).

²¹ Regulators use the terms "above-the-line" and "below-the-line" to help distinguish costs that are chargeable to ratepayers from those that shareholders must bear. Above-the-line costs are presumed to support regulated services. Below-the-line costs are presumed to support other activities.

costs, and access rules.²² Similar data were collected from AT&T until its reclassification as a nondominant carrier.²³ Furthermore, when an ILEC moves to price cap regulation, its interstate access rates established under rate-of-return regulation form the basis for the price cap filing, just as AT&T's interstate rates were the starting point for its conversion to price cap regulation.²⁴ When a price cap ILEC offers a new service, it must meet the new services cost test²⁵ to establish a cost record for the service before implementing price cap pricing.

8. Most of the smaller companies, many of which are classified as "average schedule companies," keep their accounts according to the Uniform System of Accounts but are exempt from cost allocation procedures and are not required to make individual cost showings to justify their rates.²⁶ Unlike the larger "cost schedule" companies, average schedule companies are compensated for interstate common carrier services on the basis of formulas designed to simulate the disbursements that would be received by a cost schedule company²⁷ that is representative of average schedule companies. The formulas are based on sampled data from average schedule companies and from completed cost studies of representative cost schedule companies. This process is administered by the National Exchange Carrier Association (NECA).

²² The USOA report includes information from the accounts in which legal and extraordinary items are recorded. *See generally* Automated Reporting Requirements for Certain Class A and Tier 1 Telephone Companies (Parts 31, 42, 57, and 69 of the FCC's Rules), 2 FCC Rcd 5770, App. B, pp. 5, 7 (1987). The USOA is a financial accounting system. Data from the USOA is the basis for reports on the allocation of costs between federal and state jurisdictions and between regulated and unregulated activities that the Commission uses in its efforts to prevent ratepayer subsidization of anticompetitive behavior. *Id.* at App. C, p.1; App. D, p.1; 47 C.F.R. § 36.1(f). *See generally also* Annual 1989 Access Tariff Filings, *Memorandum Opinion and Order*, 4 FCC Rcd 3638, at 3638-39, ¶¶ 5-9 (Com. Car. Bur. 1989) (brief review of rate methodology mandated by FCC access charge rules). ARMIS data are also used in the Commission's periodic evaluation of carrier price cap performance and tariff filings.

²³ *See generally* Elimination of FCC Form 901, Monthly Form Required from Telephone Companies, CC Docket No. 87-503, *Report and Order*, 3 FCC Rcd 6261 (1988). *See also* Motion of AT&T to be Reclassified as a Non-Dominant Carrier, *Order*, 11 FCC Rcd 3271 (1995).

²⁴ *LEC Price Cap Order*, 5 FCC Rcd at 6814, ¶ 230.

²⁵ *See* Section 61.49(g)(2), 47 C.F.R. 61.49(g)(2). Tariff filings for new services must "be accompanied by cost data sufficient to establish that the new service ... will not recover more than a reasonable portion of the carrier's overhead costs."

²⁶ These companies are considered to be too small to warrant the burden of developing cost information. *See generally* Separation of Costs of Regulated Telephone Service from Costs of Non-regulated Activities, CC Docket No. 86-111, *Order on Reconsideration*, 2 FCC Rcd 6283, 6300, ¶ 155 (1987).

²⁷ The smaller companies with fewer than 50,000 access lines are classified as subset 3 carriers and may be classified as either "cost schedule" or "average schedule," carriers. These carriers, unless they are exempt under Section 2(b)(2) of the Communications Act, 47 U.S.C. § 152(b)(2), are required to keep their accounts according to the Uniform System of Accounts but are generally not required to submit cost data with their tariff filings. "Cost schedule" carriers should, however, be prepared to provide cost support data if requested by the Commission. *See* 47 C.F.R. § 61.39.

C. Litigation Costs

9. Historically, the Commission allowed carriers to record litigation expenses in above-the-line accounts and retained the option of disallowing such costs on an *ad hoc* basis in ratemaking proceedings.²⁸ Litigation tended to arise from contract disputes, tort liability for accidents, or worker's compensation claims, which were viewed as matters arising out of the ordinary course of business. Penalties and fines paid on account of violations of statutes, however, were recorded below the line.²⁹

10. In the 1970's, government and private antitrust litigation involving AT&T and other carriers subject to the Commission's jurisdiction increased substantially. Anticipating the need to determine whether the large sums AT&T spent defending these antitrust suits should be charged to ratepayers or shareholders, the Commission initiated a Notice of Inquiry in 1979 to develop a policy of general applicability so that it could avoid having to make this determination in each future rate proceeding.³⁰ The Commission concluded that tariff and rate case review mechanisms provided suitable fora for identifying and disallowing such costs. Additionally, however, the Commission asked the Telecommunications Industry Advisory Group that was rewriting the Uniform Systems of Accounts for telephone companies whether more detailed accounts or reports for litigation expenses were needed.³¹

11. The Commission revisited the question after the substantial treble damages antitrust judgment in the *Litton Systems* case became final against AT&T and its former subsidiaries, the regional Bell operating companies.³² The Commission ordered AT&T and the regional Bell operating companies to record the *Litton Systems* judgment below-the-line in the nonoperating account used for penalties and fines for violating statutes, and it further ordered that they credit the operating accounts in which they had carried their defense costs and reclassify these costs to the same nonoperating account in which the judgment was to be recorded. Although this was only an accounting change, this change presumptively removed these costs from the ratemaking

²⁸ See generally Policy to be Followed in the Allowance of Litigation Expenses of Common Carriers in Ratemaking Proceedings, CC Docket No. 79-19, *Memorandum Opinion and Order*, 92 FCC 2d 140 (1982) (*Litigation Expenses Order*).

²⁹ See 47 C.F.R. § 31.370 (1985).

³⁰ Policy to be Followed in the Allowance of Litigation Expenses of Common Carriers in Ratemaking Proceedings, CC Docket No. 79-19, *Notice of Inquiry*, 70 FCC 2d 1961, 1961-62 (1979); *Litigation Expenses Order*, 92 FCC 2d at 140.

³¹ The Advisory Group made no substantive recommendation but, instead, proposed a separate expense account for litigation and antitrust lawsuits, a proposal not adopted by the Commission. *Litigation Costs Order*, 2 FCC Rcd at 3242 ¶ 6.

³² *Litton Systems, Inc. v. American Tel. and Tel. Co.*, 700 F.2d 785 (2d Cir. 1983), *cert. denied*, 464 U.S. 1073 (1984). Litton had alleged unlawful monopolization of the telephone terminal equipment market.

process.³³ After the Commission denied reconsideration, the carriers sought judicial review of accounting treatment and resulting presumption for their litigation expenses. They did not challenge the treatment of the antitrust judgment or the interest thereon.

12. The Commission also conducted a rulemaking proceeding to clarify the accounting treatment of litigation costs incurred in both antitrust lawsuits and other lawsuits in which violation of any federal law was alleged.³⁴ It concluded that payments incurred as a result of adverse antitrust judgments or post-judgment settlements should be recorded below the line in a nonoperating account,³⁵ but allowed ratemaking recognition of the saved litigation expenses of the suit.³⁶ The ongoing costs of defending the litigation would continue to be recorded in an operating account as accrued but would be transferred to a nonoperating account when a judgment adverse to the carrier became final or if a settlement were entered after an adverse judgment.³⁷ This accounting treatment was extended to litigation costs arising from alleged violations of any federal law.³⁸ As with the *Litton Accounting Order*, this treatment presumptively removed from the ratemaking process the litigation costs other than certain pre-judgment settlement costs arising from a carrier's violation of antitrust and other federal laws, and shifted to the carriers the burden of showing the reasonableness of including such costs in their revenue requirements. This, too, was challenged.

13. The Court of Appeals for the District of Columbia Circuit vacated both Commission orders on the same day and remanded each case for further proceedings. In *Litton Accounting Appeal*,³⁹ the court was not persuaded that the illegality of the underlying carrier conduct was a sufficient reason, by itself, for exclusion of the litigation defense expenses from ratemaking and

³³ American Tel. & Tel. Co., *et al.*, Accounting instructions for the judgment and other costs associated with the *Litton Systems* antitrust lawsuit, 98 FCC 2d 982, 984-86 (1984) (*Litton Accounting Order*), *recon. denied*, 3 FCC Rcd 500 (1988) (*Litton Accounting Recon. Order*). The Commission did not order any accounting adjustments for the costs in other antitrust cases that AT&T settled, including *Carter v. American Tel. & Tel. Co.*, Civ. A. No. 3-1294 (N.D. Tex. 1969) (*Carterfone* settled for \$480,000); *Wyly Corp. v. American Tel. & Tel. Corp.*, Civil Action No. 76-1544 (D.D.C. 1980) (settled for \$50,000,000); and *United States v. AT&T*, 552 F.Supp. 131 (D.D.C. 1982), *aff'd sub nom. Maryland v. United States*, 460 U.S. 1001 (1983) (settlement resulted in Modified Final Judgment and divestiture of AT&T's regional operating companies). *Litigation Costs Order*, 2 FCC Rcd at 3245, ¶ 25, 3258, n.20; *Litton Accounting Order*, 98 FCC 2d at 984, ¶ 8 & n.4, 987-88, ¶ 17.

³⁴ *Litigation Costs Proceeding*, note 2, *supra*.

³⁵ *Litigation Costs Order*, 2 FCC Rcd at 3241, ¶ 3.

³⁶ *Litigation Costs Recon. Order*, 4 FCC Rcd at 4097-98.

³⁷ *Id.* at 4099.

³⁸ *Litigation Costs Order* at 3247-48, ¶ 41.

³⁹ *Mountain States Telephone and Telegraph Company v. Federal Communications Commission*, 939 F.2d 1021 (D.C. Cir., 1991) (*Litton Accounting Appeal*).

admonished the Commission to scrutinize the reasonableness of the expenses with "a wider and more discriminating focus."⁴⁰ The court also found that the Commission's policy was not sufficiently explained.⁴¹

14. In *Litigation Costs Decision*, the court remanded the Commission's *Litigation Costs Proceeding* because: (1) the Commission did not adequately justify application of the rules to violations of federal law other than antitrust law; and (2) the Commission did not sufficiently consider the probable effects of its rule on the companies' incentives to either settle or litigate lawsuits.⁴² The court also stated that the Commission had failed to explain why its reclassification of litigation costs was not retroactive ratemaking.⁴³ Although the court vacated the Commission's orders, it specifically acknowledged the Commission's "special responsibility . . . regarding the competitive behavior of the common carriers subject to its oversight."⁴⁴ In discussing the accounting treatment for antitrust judgments, the court stated that the Commission may disallow any expense incurred as a result of carrier conduct that cannot reasonably be expected to benefit ratepayers and that the Commission acted reasonably in aligning the presumption against recovery with the majority of antitrust cases in which consumers do not benefit from the conduct occasioning liability.⁴⁵ The court found no fault with the Commission's treatment of either adverse antitrust judgments or pre-judgment settlements in antitrust cases, although it faulted the Commission for failing to consider the possible perverse incentives arising from its asymmetric treatment of post-judgment settlements, which ultimately could also increase the amount recoverable from ratepayers. The court agreed that the same rationale that the Commission used in determining that an ILEC could not recover an antitrust judgment also applies with respect to litigation expenses because the reasonableness of the underlying conduct, not the defense of the conduct, determines whether the expense is reasonable.⁴⁶

⁴⁰ *Litton Accounting Appeal*, 939 F.2d at 1033.

⁴¹ *Id.* at 1035. On remand the Commission concluded that further action in the *Litton Accounting Proceeding* was not warranted. *American Tel. and Tel. Co., et al. - Accounting Instructions for the Judgment and Other Costs Associated with the Litton Systems Antitrust Lawsuit*, 8 FCC Rcd 7062 (1993). The Commission noted that the accounting reclassification of the *Litton* litigation expenses to a nonoperating account was not followed by actual recapture of those expenses in the 1985 Access Tariff proceeding, so the potential ratemaking consequences that concerned the court were not realized.

⁴² *Litigation Costs Decision*, 939 F.2d at 1042.

⁴³ *Id.* at 1044.

⁴⁴ *Id.*

⁴⁵ *Id.* at 1043.

⁴⁶ *Id.*

III. CURRENT PROPOSAL

15. In the current docket, the Commission has proposed accounting rules that would: require carriers to account for adverse antitrust judgments and post-judgment antitrust settlements below the line in Account 7370, a nonoperating account for special charges; defer other antitrust litigation expenses during the pendency of antitrust litigation; and account for the expenses below the line in the event of an adverse judgment or a post-judgment settlement.⁴⁷ If a pre-judgment settlement occurred, the litigation expenses actually incurred and any avoided costs of litigation that are a direct result of the settlement of the suit would be booked below the line in a nonoperating account but recovered in the ratemaking process. The Commission has also proposed that any rules adopted will be applicable to state as well as federal antitrust lawsuits and also to non-antitrust lawsuits involving violation of federal statutes in which the actions giving rise to the litigation did not benefit ratepayers. Pending action on these proposals, carriers have been recording antitrust judgments and settlements in Account 1439, Deferred charges, with the expectation that these charges would be treated in accordance with any rules ultimately adopted in this docket.⁴⁸

IV. COMMENTS

16. Comments generally opposing the proposal were received from the United States Telephone Association (USTA), the Ameritech Operating Companies (Ameritech), the Bell Atlantic Telephone Companies (Bell Atlantic), BellSouth Telecommunications, Inc. (BellSouth), the New England Telephone and Telegraph Company and New York Telephone Company (NYNEX), Pacific Bell and Nevada Bell (the Pacific Companies), Southwestern Bell Telephone Company (SWBT), U S West Communications, Inc. (U S West), and COMSAT Corporation (COMSAT). MCI Telecommunications Corporation (MCI) and Scott J. Rafferty (Rafferty) filed comments generally supporting the proposal. Reply comments were received from MCI, Rafferty, USTA, BellSouth, NYNEX, the Pacific Companies, SWBT, COMSAT, and GTE Service Corporation and its affiliated domestic telephone operating companies (GTE).

V. DISCUSSION

A. Need for Rule Change

17. The question in this proceeding is a narrow one: whether the Commission should by rule revise the accounting treatment for costs associated with litigation, particularly antitrust litigation. As commenters have emphasized, however, the consequences are broader. Parts of the proposal in the *NPRM*, if adopted as proposed, would change presumptions of recovery of the costs in ratemaking proceedings, impose tracking and recordkeeping burdens on the subject

⁴⁷ *NPRM*, 8 FCC Rcd at 6657-6659.

⁴⁸ *Id.* at 6659-60.

carriers, and affect incentives to litigate. In addressing the issues raised by our proposal, we have carefully considered these consequences. We have also considered the proposal in the context of changes in our regulation of the ratemaking process relevant to the proposed accounting changes.

18. We have concluded that our rules should require that adverse antitrust judgments be accounted for below-the-line in Account 7370. This would include any associated interest and awards of attorneys fees to adversaries. Fines and penalties have always been accounted for below-the-line, and this practice will continue. We have also concluded that settlement costs paid by carriers to resolve antitrust litigation should be accounted for below-the-line in Account 7370, but we have modified our proposal to allow carriers to recover in ratemaking the saved litigation expenses of both pre- and post-judgment settlements entered before any adjudication of anticompetitive misconduct becomes final. We have also concluded that we should change how we treated the costs of defending antitrust litigation. In the previous rulemaking, we allowed litigation expenses associated with a adverse judgment or a post-judgment settlement to be recorded above-the-line but made them subject to "recapture." This recapture doctrine created a presumption that these expenses would be excluded from a carrier's revenue requirements.⁴⁹ In the present rulemaking, we alter the presumption to provide that these costs may continue to be recorded above the line in operating accounts. Finally, we have concluded that the record before us provides insufficient basis for changing the current accounting treatment of alleged or adjudicated violations of state or federal laws other than federal antitrust laws. This means that only costs related to judgments or settlements in lawsuits stemming from violations of federal antitrust laws will be recorded below-the-line. With regard to settlements of such lawsuits, there will be a presumption that carriers can recover the portion of the settlement that represents the avoidable costs of litigation, provided that the carrier makes the required showing, as defined in paragraphs 45-46, *infra*.

19. USTA and BellSouth have argued that antitrust litigation has not occurred often enough within recent years to constitute a problem within the industry.⁵⁰ We disagree with the contention that a recent decline in antitrust litigation establishes that such litigation could not occur again. We do not find this to be a persuasive reason for failing to be prepared for determining the proper accounting treatment for antitrust litigation expenses. Our past experience in trying to make such determinations on an *ad hoc* basis persuades us that the certainty provided by a clear rule is preferable and that the time to define that rule is when carriers are not

⁴⁹ *Depreciation Simplification NPRM*, 8 FCC Rcd at 6656.

⁵⁰ USTA at 13 (no significant adverse judgments within last 10 years); BellSouth at 19-21 (no adverse antitrust judgment or settlement within the last 4 years that would have triggered a disallowance). This is perhaps explained by the court's observation in *MCI Communications Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081, 1110 (7th Cir.), *cert. denied*, 464 U.S. 891 (1983) (*MCI v. AT&T*), that the sweeping procompetitive changes in the telecommunications industry, occurring at the direction of regulatory authorities, are meeting the broadest objectives of the antitrust laws at least as effectively as they might be pursued in cases such as *MCI*.

embroiled in major litigation.⁵¹ Because adequate rules were not in place during the 1970's and 1980's, ratepayers bore the costs of settlements in antitrust cases.⁵² Ratepayers and taxpayers alike bore the costs of litigating how litigation costs should be booked in the *Litton Accounting Proceeding*.

20. We are also unpersuaded by the argument that we should not determine the accounting treatment for the smaller ILECs, because the smaller ILECs, those not required to use price caps, are not likely to violate the antitrust laws.⁵³ When the Commission distinguished dominant from nondominant carriers in its competitive carrier rulemaking, it determined whether a firm possessed market power, or the power to control prices,⁵⁴ by looking at market features, including "the number and size distribution of competing firms, the nature of barriers to entry, . . . the availability of reasonably substitutable services," and whether the firm controlled "bottleneck facilities."⁵⁵ All ILECs were considered to be dominant because they possessed these characteristics within their service areas, even if not on a national basis, and the Commission has not changed this categorization for the ILECs.⁵⁶ In the *Virtual Collocation Rates Phase I Report and Order*,⁵⁷ the Commission disagreed with the assertion that an ILEC has no economic incentive to engage in anticompetitive behavior. Noting that the Common Carrier Bureau had concluded in its tariff suspension order that the Tier 1 ILECs were strategically assigning high overhead loadings to deter competitive entry into the interstate access service market,⁵⁸ and

⁵¹ Cf. *Joint Costs Recon. Order*, 2 FCC Rcd at 6304, ¶ 185 (audits of cost allocation practices appropriate to ensure compliance with rules even though nonregulated costs and revenues may still be relatively small).

⁵² See *Litigation Costs Order*, 2 FCC Rcd at 3245, ¶ 25 & n. 20; *Litton Accounting Order*, 98 FCC 2d at 984, 987-88.

⁵³ USTA at 15, arguing that LECs not under price caps do not control national markets.

⁵⁴ 47 C.F.R. § 61.3(o).

⁵⁵ *Competitive Carrier Proceeding*, 85 FCC 2d at 21, ¶¶ 57-58, quoted in *AT&T Reclassification*, FCC 95-427 at ¶ 5.

⁵⁶ *Competitive Carrier Proceeding* at 23-24, ¶ 65; MTS and WATS Market Structure, Phase I, 93 FCC 2d 241, 338, ¶ 360 (1983) ("Exchange carriers, even small ones, enjoy a dominant monopoly position in their local service area. . . . Indeed the smallest exchange carriers are probably even more dominant than the large ones because bypass competition is very unlikely to develop in the areas they serve."). See also *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket 96-98, FCC 96-325 at ¶ 1330 (rel. August 8, 1996).

⁵⁷ *Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection Through Virtual Collocation for Special Access and Switched Transport, Phase I, Report and Order*, 10 FCC Rcd 6375 (1995) (*Virtual Collocation Rates Phase I Report and Order*).

⁵⁸ See *Ameritech Operating Cos., Revisions to Tariff F.C.C. No. 2, Order*, 10 FCC Rcd 1960, 1973-74, ¶ 22 (Com. Car. Bur. 1994). Tier 1 exchange carriers are those with more than \$100 million in annual revenues for a sustained period of time. Similar criteria are used to distinguish between Class A and Class B companies for the

finding that the ILECs had not justified their overhead loading levels, the Commission rejected the ILEC virtual collocation rates as unjust and unreasonable and ordered a refund. "While predation may be infrequent, under certain market conditions it may be a profitable strategy."⁵⁹ The Commission further observed that anticompetitive pricing can also occur when a monopoly provider assigns high overheads to bottleneck facilities upon which competitors rely, while assigning low overheads to the services against which competitors seek to compete.⁶⁰ In *Intelligent Network*, the Commission's concern about ILEC resistance to open network policies led to a proposal that Tier 1 ILECs be required to open their networks to potential competitors to some degree.⁶¹ The Commission can make its best efforts to minimize anticompetitive behavior but cannot guarantee that carriers who could potentially restrict entry or affect prices will not commit violations of the antitrust laws in the future. It is in the public interest to have accounting rules in place if judgments do occur. The rules we are enacting in this Order do not impose burdens on conforming carriers.

21. Although this rulemaking proceeding addresses the narrow issue of the appropriate accounting treatment for antitrust litigation costs, it must be viewed in the broader context of our responsibility under Title II, Section 201(b) of the Communications Act to ensure that all rates charged by carriers are lawful, *i.e.*, that they are "just and reasonable." This means that a carrier's operating expenses recovered through tariffed rates must be "legitimate" costs of providing service to ratepayers.⁶² Carriers argue that the treatment of litigation costs may not directly affect

purposes of our Part 32 Accounting Rules. Commission Requirements for Cost Support Material To Be Filed With 1990 Annual Access Tariffs, 5 FCC Rcd 1364, 1364, ¶ 3 (Com. Car. Bur. 1990). The 1996 Act requires adjustment of Part 32's 100 million threshold for inflation changes. See 1996 Act, § 402(c), and Implementation of the Telecommunications Act of 1996: Reform of Filing Requirements and Carrier Classifications, *Order and Notice of Proposed Rulemaking*, CC Docket 96-193, FCC 96-370 (rel. September 12, 1996).

⁵⁹ *Virtual Collocation Rates Phase I Report and Order*, 10 FCC Rcd 6375, 6402 at n.147, citing Paul Joskow & Alvin Llevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 Yale L.J. 213 (1979); Janusz A. Ordover & Garth Saloner, *Predation, Monopolization, and Antitrust*, in Richard Schmalensee & Robert Willig, *Handbook of Industrial Organization*, 537, 550-62, 590 (1989).

⁶⁰ *Id.* at ¶ 71, at n.148, citing Janusz A. Ordover & Garth Saloner, *Predation, Monopolization, and Antitrust*, in Richard Schmalensee & Robert Willig, *Handbook of Industrial Organization*, 537, 565-70 (1989); T.G. Krattenmaker and Steven Salop, *Anticompetitive Exclusion: Raising Rivals' Costs to Achieve Power Over Price*, 96 Yale L.J. 209 (1986); Steven Salop and D.T. Scheffman, *Raising Rivals' Costs*, 73 American Econ. Rev. 267 (1983).

⁶¹ *Intelligent Networks, Notice of Proposed Rulemaking*, 8 FCC Rcd 6813, 6815, ¶ 18 (1993) (*Intelligent Networks*).

⁶² *West Ohio Gas Co. v. PUC*, 294 U.S. 63, 74 (1935) (*West Ohio Gas*); *Tennessee Gas Pipeline v. FERC*, 606 F.2d 1094, 1109 (D.C. Cir. 1979), *cert. denied*, 445 U.S. 920 (1980). See *NAACP v. FPC*, 425 U.S. 662, 668 (1976) ("illegal, duplicative, or unnecessary" costs must be disallowed); *Litigation Costs Decision*, 939 F.2d at 1043 ("it is a legitimate aim of rate regulation to protect ratepayers from having to pay charges unnecessarily incurred;" "the FCC may disallow any expense incurred as a result of carrier conduct that cannot reasonably be expected to benefit ratepayers"), 1044 ("it is a legitimate aim of rate regulation to protect ratepayers from paying the costs a

rates for price cap carriers, but even for price cap carriers accurate cost accounting provides the basic data for determining jurisdictional separations and for enforcing the Commission's competitive policies. Additionally, the treatment of litigation costs does affect the calculation of any sharing obligations a carrier may have under price caps. We have sought a result here that will minimize the burden to carriers from this accounting change and, at the same time, avoid burdening ratepayers -- and possibly other telecommunications carriers -- from bearing the costs of anticompetitive misconduct.

B. Adverse Antitrust Judgments

22. In the *NPRM* and earlier in the *Litigation Costs Proceeding*, the Commission stated that anticompetitive behavior that leads to an adverse antitrust judgment "rarely, if ever produces any benefit for ratepayers," although the corporate strategy leading to the adverse judgment could benefit shareholders if management successfully avoids liability.⁶³ MCI agrees, and NYNEX and the Pacific Companies do not dispute this view.⁶⁴ U S West argues that this proceeding is unnecessary because antitrust judgments have always been subject to Commission scrutiny.⁶⁵ Other commenters opposing the Commission's proposal, however, argue that antitrust judgments are operating expenses incurred in the normal course of business,⁶⁶ or result from changing standards or the lack of a line between aggressive competition and anticompetitive conduct.⁶⁷

23. We are not persuaded by opponents' arguments that adverse judgments should be recorded in operating accounts. We do not share opponents' views that anticompetitive behavior is the business of a carrier or that the cost of antitrust violations is a normal cost of doing business. The Commission increasingly relies on competition to control prices and stimulate new entrants and services, and has expended considerable effort to prevent anticompetitive conduct. An antitrust judgment results only after a court concludes, on the basis of the evidence before it, that the conduct at issue has violated the law. The antitrust laws define impermissible conduct, and carriers, like other businesses, push the line between aggressive competition and anticompetitive conduct at their own risk. Although, as BellSouth and SWBT argue, different

carrier incurs for an activity that is not undertaken for their benefit"), 1045 (a "'right' decision" [is] what the ratepayers would have decided in their own economic self-interest").

⁶³ *NPRM*, 8 FCC Rcd at 6656-57, ¶ 9, quoting *Litigation Costs Order*, 2 FCC Rcd at 3244, ¶ 21. See also *Litigation Costs Decision*, 939 F.2d at 1043.

⁶⁴ NYNEX at 4, 7; Pacific Companies at 4; MCI at 4. NYNEX acknowledges that judgment costs can reasonably be presumed not to benefit ratepayers.

⁶⁵ U S West at 4-5; accord, SWBT at 14.

⁶⁶ See BellSouth at 6-7; COMSAT at 3; SWBT at 12-13.

⁶⁷ BellSouth at 24-27; COMSAT at 9-10; SWBT at 10, 13.

federal antitrust courts may draw different conclusions from seemingly similar circumstances,⁶⁸ the court is the appropriate forum for testing the evidence and arguing its weight, and the system provides for appeals of an unfavorable judgment. While it may also be true that the understanding of what constitutes anticompetitive conduct evolves as different types of conduct are scrutinized under the antitrust lens,⁶⁹ we find that this is not a reason for this Commission to make light of an adjudicated antitrust violation. Competition may be "a ruthless process," as COMSAT advises,⁷⁰ but the antitrust laws place limits, as COMSAT acknowledges. We consider it inappropriate to use our accounting prescription and the accompanying ratemaking presumptions to lessen the compliance incentives created by the antitrust laws,⁷¹ which could occur if we placed some or all of the monetary risk of an adjudicated violation on ratepayers rather than shareholders. U S West's and SWBT's argument that the expense may be disallowed on a case-by-case basis does not take into account the burden on ratepayers or the Commission when seeking disallowance in a ratemaking proceeding after a carrier has been adjudicated to be a wrongdoer. In our view, where anticompetitive conduct occurs, the burden is more appropriately placed on the carrier, which has the information about its conduct. This is fully consistent with the Commission's requirement in *Litton Accounting Proceeding* that the adverse judgment be accounted for below-the-line.⁷²

24. SWBT argues that antitrust liability may be imposed even when the conduct at issue consists of the carrier adhering to its tariffs, which it is required by law to do, and even when conduct such as under-allocating the costs of some services is required of carriers by the Commission or state regulators to achieve policy goals.⁷³ This argument is akin to the implied immunity defense sometimes raised in antitrust litigation involving a regulated entity. If a carrier is caught between incompatible regulatory requirements and antitrust enforcement, or if its conduct resulted from good faith adherence to regulatory requirements, it should make these points as a defense in the antitrust litigation where they can be weighed along with the challenged

⁶⁸ BellSouth at 25-26, comparing *MCI v. AT&T*, 708 F.2d 1081 (jury verdict against AT&T upheld), with *Southern Pacific Comm. Co. v. American Tel. & Tel. Co.*, 740 F.2d 980 (D.C. Cir. 1984) (verdict in AT&T's favor upheld), cert. denied, 470 U.S. 1005 (1985); SWBT at 10 (same).

⁶⁹ See SWBT at 10.

⁷⁰ COMSAT at 10, quoting *Ball Memorial Hospital, Inc. v. Mutual Hosp. Ins.*, 784 F.2d 1325, 1338, reh'g denied, 788 F.2d 1223 (7th Cir. 1986).

⁷¹ For a description of compliance incentives, see SWBT at 13-14.

⁷² American Tel. and Tel. Co., Ameritech, Bell Atlantic, BellSouth, NYNEX, Pacific Telesis, Southwestern Bell and U.S. West -- Accounting instructions for the judgment and other costs associated with the *Litton Systems* antitrust lawsuit, 98 FCC 2d 982, 983-986, 988 (1984), recon. denied, 3 FCC Rcd 500 (1988) (*Litton Accounting Proceeding*), appealed and rev'd on other grounds sub nom. *Mountain States Tel. & Tel. Co. v. FCC*, 939 F.2d 1021 (D.C. Cir. 1991) (*Litton Accounting Appeal*).

⁷³ SWBT at 11-12.

conduct.⁷⁴ Tariffs filed with the Commission are initiated by the carriers, however. The pricing decisions contained in the tariffs should reflect regulatory policy, but also the specific decisions generally reflect the carrier's business judgment rather than regulatory coercion,⁷⁵ and often are not specifically approved by the Commission. When the streamlined tariff filing process becomes effective for ILECs in February 1997,⁷⁶ advance review will be even less likely. Thus, even though a carrier is required to adhere to its tariffs in order to avoid unlawful discrimination for like communications services,⁷⁷ the carrier may comply with this requirement of the Communications Act and still commit violations of the antitrust laws. For these reasons, we are not persuaded that we should abandon our proposed requirement that antitrust judgments be recorded below-the-line in a nonoperating account.

25. COMSAT argues that antitrust lawsuits are complex and often have no clear winner or loser as, for example, when a carrier is sued for a large amount but judgment is entered against it for a lesser amount.⁷⁸ Our concern, however, is with any judgment resulting from an antitrust violation. The possibility that the outcome could have been worse does not show how the underlying conduct could be expected to benefit ratepayers and is not a sufficient basis for finding that ratepayers should be responsible for paying any judgment costs through their rates. The Court of Appeals in *Litigation Costs Decision* agreed "that it is a legitimate aim of rate regulation to protect ratepayers from having to pay charges unnecessarily incurred, including those incurred as a result of the carrier's illegal activity -- of whatever sort."⁷⁹ The court explained:

The theory of the antitrust laws supports the FCC's observation that activities that give rise to antitrust liability do not generally benefit ratepayers. See R. Bork, *The Antitrust Paradox* 7 (1978) ("the only legitimate goal of antitrust is the maximization of consumer welfare"). . . . The Commission acted quite reasonably . . . in aligning the presumption (against recovery) with the majority of

⁷⁴ For a discussion of regulation and the antitrust laws, see generally *MCI v. AT&T*, 708 F.2d at 1100-1111; see also *Southern Pacific Communications Co. v. American Tel. & Tel. Co.*, 740 F.2d at 999-1000; *Mid-Texas Communications Systems, Inc. v. American Tel. & Tel. Co.*, 615 F.2d 1372, 1377-1382 (5th Cir. 1980), *cert. denied sub nom. Woodlands Telecommunications Corp. v. Southwestern Bell Tel. Co.*, 449 U.S. 912 (1980).

⁷⁵ Cf. *Otter Tail Power Co. v. United States*, 410 U.S. 366, 374, *reh'g denied*, 411 U.S. 910 (1973) ("When . . . relationships are governed in the first instance by business judgment and not regulatory coercion, courts must be hesitant to conclude that Congress intended to override the . . . antitrust laws.")

⁷⁶ See 47 U.S.C. § 204(a)(3).

⁷⁷ 47 U.S.C. § 202(a).

⁷⁸ COMSAT at 11. COMSAT argues that the underlying conduct may benefit ratepayers.

⁷⁹ *Litigation Costs Decision*, 939 F.2d at 1043.

antitrust cases, in which consumers do not benefit from the conduct occasioning liability.⁸⁰

26. COMSAT, USTA, and SWBT argue that reliance on the *Litigation Costs Decision* panel's analysis is misplaced because, under *Litton Accounting Appeal*, the success or failure of the litigation cannot be the sole determinant of the presumptive allowance or disallowance of litigation expenses, including the expenses of an adverse judgment.⁸¹ USTA adds that the result, not the language of *Litigation Costs Decision*, is controlling because the Commission's *Litigation Costs Proceeding* was vacated in its entirety.⁸² We disagree. The petitioners in *Litton* did not challenge the Commission's decision to disallow the judgment. The issue, therefore, as to whether it is reasonable for the Commission to presumptively disallow antitrust judgments was not before the court in the *Litton Accounting Appeal*. That issue, however, was before the court in the *Litigation Costs Decision* and the court in that case expressly concluded that it was reasonable for the Commission to presumptively disallow antitrust judgments. The court explains why its remand was limited to two issues,⁸³ which specifically did not include the Commission's alignment of the presumption against recovery with the majority of antitrust cases.⁸⁴ We reject, moreover, USTA's suggestion that we interpret the *Litigation Costs Decision* in a manner that is contrary to the language and rationale of that decision.

27. We also read *Litton Accounting Appeal* more narrowly than COMSAT, USTA, and SWBT do. *Litton Accounting Appeal* dealt only with an indirect cost of the carrier's conduct, i.e., the cost of defending against allegations of anticompetitive misconduct. The court questioned whether the subsequent finding that the underlying conduct was illegal compels or warrants rejection of the defense expense in the ratemaking process, particularly when the carrier had properly tracked its expenditures in above-the-line accounts with the expectation that these would be treated as operating costs in ratemaking.⁸⁵ The Commission's accounting treatment of the adverse judgment, the direct cost of the misconduct, was not before it and, thus, not addressed by the court.⁸⁶ In reviewing the Commission's treatment of the carrier's defense costs, the court observed that, in another context, the costs of defending a carrier's business activities have been considered ordinary and necessary costs of the business. The court further observed that *Litton*

⁸⁰ *Id.* SWBT disagrees, arguing that carriers are normally guided by the profit motive and that profits would normally benefit ratepayers. SWBT at 12-13.

⁸¹ COMSAT at 4, 6-11; USTA at 6-8; SWBT at 8-9.

⁸² USTA at 3, 5 & n. 7.

⁸³ *Litigation Costs Decision*, 939 F.2d at 1042.

⁸⁴ *Id.* at 1043.

⁸⁵ *Litton Accounting Appeal*, 939 F.2d at 1029-30.

⁸⁶ *Id.* at 1026.

defense costs had previously been treated as properly incurred, and the Commission had not scrutinized the reasonableness of those costs before concluding that they were not legitimate operating expenses. We see no inconsistency between the admonition in *Litton Accounting Appeal* that we consider the reasonableness of the costs of defending against an allegation of antitrust misconduct before presumptively excluding those costs from the ratemaking process and the presumption in *Litigation Costs Decision* that the direct costs of adverse antitrust judgments do not benefit ratepayers. An adverse antitrust judgment is the outcome of court scrutiny of the carrier's conduct and the finding that misconduct caused damages of a specified monetary value. When the judgment as to damages becomes final, the judgment costs are entered in the appropriate account. There is no problem of later changing the accounting treatment, which concerned the court in *Litton Accounting Appeal*. Also, any burden on the ILECs is more than offset by the benefits of protecting ratepayers against unnecessary costs.

28. Bell Atlantic fears that rate-of-return carriers will be burdened by the need for a separate proceeding each time an antitrust action against a carrier is resolved by judgment.⁸⁷ According to USTA and BellSouth, however, adverse judgments are rare,⁸⁸ and the record contains no information to the contrary. We do not see an unreasonable burden on carriers if they seek to persuade the Commission that the underlying adjudicated misconduct was undertaken in the interest of ratepayers.⁸⁹

29. In conclusion, once a court has made an adverse determination, and that determination has become final, we will presume that the underlying conduct did not benefit ratepayers unless the carrier can make a showing to the contrary. The judgment costs must be accounted for below-the-line in Account 7370 as a nonoperating expense and, absent a showing of ratepayer benefit,⁹⁰ presumptively removed from the ratemaking process. Carriers should make any showings in a request for special relief rather than burden the ratemaking process itself with the determination.

C. Settlements

30. The Commission, in the *Litigation Costs Order*, required that all antitrust settlements be recorded below-the-line.⁹¹ On reconsideration, the Commission created a

⁸⁷ Bell Atlantic at 1-2.

⁸⁸ USTA at 13; BellSouth at 20.

⁸⁹ According to COMSAT, the overwhelming majority of antitrust suits result in settlement, which it argues reflects the fine line between vigorous competition and activities that may be viewed as an antitrust violation. COMSAT at 13 & n.30.

⁹⁰ See *Litigation Costs Decision*, 939 F.2d at 1043 (accepting ratepayer benefit test); see also note 60, *supra*; AT&T Communications, 5 FCC Rcd 5693, 5695, ¶ 17 (1990) (ratepayer benefit test is consistent with precedent).

⁹¹ *Litigation Costs Order*, 2 FCC Rcd at 3245.

presumption that a portion of pre-judgment settlements could be recoverable from ratepayers. That portion was defined as "the amount corresponding to the additional litigation expenses, expressed in present value terms, which the carrier reasonably estimates it would have paid if it had not settled and which the carrier would have allocated to the interstate jurisdiction under Part 36 of our rules, 47 C.F.R. Part 36."⁹² Although the *Litigation Costs Recon. Order* and the *NPRM*⁹³ both use the term "nuisance value" in connection with this presumption, they are referring to the definition quoted above. Because the phrase "avoided costs of litigation" describes the portion of a settlement that is potentially recoverable in the ratemaking process under the definition in the *Litigation Costs Recon. Order*, we will use that term, rather than "nuisance value," in this Order.

31. In remanding *Litigation Costs Order* to the Commission, the court agreed with the Commission's reasoning that, once the agency requires a judgment to be recorded below-the-line, "failing to accord similar treatment to a settlement of the same action would create a strong incentive for a carrier to settle such a suit even if the settlement is for an amount greater than the expected liability."⁹⁴ The court accepted the concept of a nuisance value exception, also known as the avoided costs of litigation exception to the presumption against recovery of settlement costs⁹⁵ but faulted the Commission for failing to address the incentives it created by treating the value of the avoided costs of litigation of pre- and post-judgment settlements disparately, because "the economics of the two situations are identical."⁹⁶

32. Relying on the court's analysis, the Commission again proposed that carriers record antitrust settlements below-the-line, in Account 7370 because "this approach is most consistent with the underlying principle that expenses not incurred for the benefit of ratepayers should not be routinely passed on to ratepayers."⁹⁷ It also asked for comment on readopting an exemption from this treatment for the litigation expenses saved by pre-judgment settlements, but not for such expenses saved by post-judgment settlements.⁹⁸

33. The treatment of settlements poses a more complex problem than does the treatment of adverse judgments, for, as commenters remind the Commission, liability is neither established

⁹² *Litigation Costs Recon. Order*, 4 FCC Rcd at 4097-98.

⁹³ *NPRM*, 8 FCC Rcd at 6656 & n. 9 (Uses the term "nuisance value" but cites the "avoided costs of litigation" definition in the *Litigation Costs Recon. Order*).

⁹⁴ *Litigation Costs Decision*, 939 F.2d at 1046.

⁹⁵ *Id.*

⁹⁶ *Id.* at 1047.

⁹⁷ *NPRM*, 8 FCC Rcd at 6657, ¶ 11.

⁹⁸ *Id.* at ¶¶ 12-15.

nor admitted. MCI argues that all settlement costs should be accounted for below-the-line and presumed not recoverable from ratepayers unless the carrier can show that the settlement was in the interests of ratepayers. If the avoided litigation costs are allowed in the revenue requirement, MCI advocates that a low dollar limit on that value should be set.⁹⁹ Other commenters assert that settlement is a business decision and should be evaluated only on the basis of the reasonableness of that decision in light of all the factors affecting the decision.¹⁰⁰ They oppose any rule that requires accounting for settlement costs below-the-line, particularly where this treatment would result in disallowing these costs from a carrier's revenue requirements.¹⁰¹ In the alternative, they argue that the Commission, in ratemaking, should at least allow carriers to recognize the litigation costs that are avoided because of a settlement, regardless of whether the settlement occurs before or after any adverse judgment.¹⁰²

34. Our ultimate objective in resolving the accounting treatment of antitrust settlements is to ensure that ratepayers obtain just and reasonable rates and ensure that expenses not incurred for the benefit of ratepayers are not recovered from them. In pursuing this objective, we are also mindful that rates are not just and reasonable if a carrier cannot recover legitimate and prudent expenses incurred in operating the business for the benefit of ratepayers, plus a fair return on its investment. We also seek a resolution that avoids burdening carriers and their ratepayers with unnecessary administrative costs and avoids creating regulatory incentives to litigate or settle on the part of carriers and their adversaries.

35. With these goals in mind, we conclude that the Commission's accounting rules should treat monetary settlements of antitrust litigation like adverse antitrust judgments. As the court acknowledged in *Litigation Costs Decision*, failing to do so could create an incentive to settle antitrust litigation even if the settlement exceeds the expected liability.¹⁰³ We also agree with the court that:

[F]ailing to require settlements to be recorded below-the-line would obviously compromise the integrity of the regulatory scheme: if the activity resulting in the lawsuit was for the benefit of the carrier, rather than for that of the ratepayers, there is no reason for

⁹⁹ MCI at 7-9. In Reply Comments at 16, MCI posits that settlements should be excluded from the ratebase unless the carrier can demonstrate that it was in the interest of ratepayers to engage in the conduct that led to the lawsuit and that settlement is in the public interest.

¹⁰⁰ E.g., USTA at 23-24.

¹⁰¹ E.g., Pacific Companies at 5.

¹⁰² E.g., BellSouth at 29-30; Pacific Companies at 11.

¹⁰³ *Litigation Costs Decision*, 939 F.2d at 1046.

requiring ratepayers to pay the cost of the settlement, even if it is in an amount less than the carrier's expected liability.¹⁰⁴

36. Most commenters argue that a settlement cannot be used as an admission of misconduct,¹⁰⁵ and they object to any implication that a carrier settles a lawsuit because a violation occurred.¹⁰⁶ The Commission does not presume that the conduct at issue in a lawsuit is unlawful until a judgment to that effect becomes final. We do not intend to dismiss allegations of anticompetitive misconduct by accepting antitrust settlements, no matter how large, as business as usual. The Pacific Companies argue that settlement¹⁰⁷ conserves judicial resources and reduces business uncertainty, and that settlement benefits ratepayers by permitting parties to resolve their differences at reduced costs and freeing business to spend resources on providing services.¹⁰⁸ Such benefits may follow from settlements, but this does not eliminate our special concern that antitrust settlements should be shown to benefit ratepayers before ratepayers are required to pay for them. NYNEX argues that the Commission can always disallow settlement costs in ratemaking if there is evidence of improper incentives, such as agreeing "to a settlement that is judged excessive when compared to the probability of a violation being found and the expected litigation expenses and judgment."¹⁰⁹ MCI questions whether this is likely in light of *Litton Accounting Order* in which an allowance and subsequent disallowance were overturned.¹¹⁰ NYNEX also argues that competitive marketplace forces provide a disincentive for bearing unnecessary costs. We note that the NYNEX test for an excessive settlement could require Commission evaluation of the underlying lawsuit, we therefore reject it as unduly subjective. The Pacific Companies argue that ratepayer benefit is found in the general policy favoring settlement.¹¹¹ This policy benefits courts and litigants by reducing caseloads, but does not explain why ratepayers should bear the full burden of settlement. The majority of commenters strongly prefer that all settlement costs be treated as operating expenses. As a fallback, however, they

¹⁰⁴ *Id.*

¹⁰⁵ NYNEX at 8; BellSouth at 30-31; COMSAT at 14-15; *see also* SWBT Bell at 14-15.

¹⁰⁶ Pacific Companies at 5-6; *see also* COMSAT at 16 (any limit on presumptive allowance of settlement costs in ratemaking treats a settlement as tantamount to an adjudication of liability). According to Pacific Companies at 7, however, "the company's belief in its own guilt or innocence" is one of several factors that would be weighed. In MCI's view, a carrier is likely to settle to avoid the presumed greater costs of the ultimate judgment, whether or not the "nuisance" or avoided litigation costs are recognized. MCI at 8.

¹⁰⁷ NYNEX at 9.

¹⁰⁸ Pacific Companies at 7; *accord* COMSAT at 14.

¹⁰⁹ NYNEX at 8-9.

¹¹⁰ MCI Reply at 15.

¹¹¹ Pacific Companies at 6-7.

support adoption of a presumption that at least the avoided litigation costs of a lawsuit is recoverable from ratepayers.

37. We recognize that litigation involves risks, uncertainties and expense. We also recognize that carriers consider factors other than fear of an adverse judgment in reaching a settlement,¹¹² and that there may be benefits to ratepayers from avoiding litigation costs in some instances. Settlement payments beyond the avoidable costs of litigation, however, raise questions about whether such payments would be reasonable or necessary if there were not a possibility that the carrier would be found to have engaged in anticompetitive conduct. In light of our duty to prevent ILECs from charging rates based upon "illegal, duplicative, or unnecessary" costs,¹¹³ we again conclude that carriers must justify recovery of payments to settle a lawsuit by showing the factors inducing the carrier to settle and demonstrating the benefit to the ratepayers.

38. SWBT objects to the Commission's proposal, arguing that allowing recovery of the avoided litigation costs of settlements entered before judgment creates an artificial incentive to settle early, before much is spent on discovery and pretrial motions for summary decision are resolved. One alleged harm is that a carrier will have less incentive to settle as the case proceeds toward trial, because fewer future costs will be available for inclusion in the calculation of avoided litigation costs.¹¹⁴ This argument fails to take into account the numerous factors SWBT and other commenters advise will affect settlement decisions, particularly as trial preparation continues and the parties gain insight into the strengths and weaknesses of each other's positions. Another alleged harm is that limiting ratemaking recognition to the avoided litigation costs will discourage carriers from aggressively litigating nuisance suits in order to deter future suits, thereby creating an artificial incentive for adversaries to bring suits of dubious merit.¹¹⁵ Absent the limitation to the avoidable litigation costs of settlements, SWBT argues, a carrier might litigate aggressively to deter meritless suits or excessive claims in the future, even though a case could be settled for less than the litigation costs, in order to keep future settlement claims reasonable. If limited to the avoidable costs of litigation, SWBT continues, a carrier would be inclined to pay up to the avoidable costs limit, even if that is excessive under the circumstances. In the *Litigation Costs Decision*, however, the court stated that "we do not accept the intervenors' claim that the rule providing for a pre-judgment settlement to be recorded above-the-line only to the extent of its 'nuisance value' (that is, in the amount of estimated litigation expenses avoided

¹¹² See *Litigation Costs Order*, 2 FCC Rcd at 3245 ¶ 26. See also USTA at 23-24 (listing factors); COMSAT at 14 (same); Pacific Companies at 7-8 (same). For a discussion of factors affecting settlement, see Steven Salop & Lawrence White, *Economic Analysis of Private Antitrust Litigation*, 74 Geo. L.J. 1001, 1017-30 (1986); Robert Halper, *The Unsettling Problems of Settlement in Antitrust Damage Cases*, 32 Antitrust L.J. 98 (1966).

¹¹³ See *NAACP v. FPC*, 425 U.S. at 668, cited in *Litigation Costs Decision*, 939 F.2d at 1043.

¹¹⁴ SWBT at 16-17.

¹¹⁵ *Id.* at 17-18.

by reason of the settlement) provides an undue disincentive for carriers to settle lawsuits."¹¹⁶ An adversary who knows that the carrier's incentive is either to settle quickly for no more than the avoidable costs of the litigation or to litigate aggressively may be more inclined to settle, however. Our proposal would not hinder a carrier from either settling for less than the avoidable costs of litigation, where warranted, or to litigating aggressively. As discussed later,¹¹⁷ the costs of the litigation will be borne by the ratepayers if not recovered from the adversary, and, if the suit lacks merit as SWBT contends, there should be no judgment adverse to the carrier. While SWBT might prefer that recognition of the costs of settlements be unlimited, we find its criticism of the proposal to limit recognition of the settlement costs of antitrust lawsuits to the avoidable costs of litigation to be unpersuasive.

39. The Commission previously limited only to pre-judgment settlements the presumption that avoidable costs of litigation should be allowed and, although the court had directed it to consider the incentive effects of any pre- and post-judgment distinction, the Commission again proposed to limit the presumption of recoverability for the avoidable costs of litigation to pre-judgment settlements.¹¹⁸ It reasoned that a post-judgment settlement occurs only after a court has made findings that a carrier engaged in illegal activity. Most commenters oppose this distinction. They argue that, while many of the same considerations that impel settlement at the trial level are relevant to settlement at the appeal level,¹¹⁹ the outcome can change as a result of an appeal,¹²⁰ and the distinction creates an incentive for protracted post-judgment litigation.¹²¹

40. On further analysis, we have decided to abandon the distinction between pre- and post-judgment settlements in cases where a finding of antitrust liability has not become final. As the court advised in *Litigation Costs Decision*, "the economics of the two situations are identical."¹²² Furthermore, we are presumptively allowing above-the-line accounting for all defense costs, including those incurred after an adverse judgment. Creating a presumption in

¹¹⁶ *Litigation Costs Decision*, 939 F.2d at 1046.

¹¹⁷ See ¶¶ 49-52, *infra*.

¹¹⁸ *NPRM*, 8 FCC Rcd at 6657, ¶ 15.

¹¹⁹ *E.g.*, BellSouth at 30-31, citing and quoting Notice of Proposed Rulemaking to Amend Part 31 Uniform System of Accounts for Class A and Class B Telephone Carriers to Account for Judgments and Other Costs Associated With Antitrust Lawsuits, and Conforming Amendments to Annual Report Form M, CC Docket No. 85-64, Reply Comments of the Section of Antitrust Law of the American Bar Association, filed July 15, 1985, at p. 7.

¹²⁰ COMSAT at 18; Pacific Companies at 10. We note that, in *MCI v. AT&T*, 708 F.2d 1083, on which Pacific Companies rely, retrial was ordered on the damages issue, not the question of antitrust liability. The finding of liability became final before the retrial with the denial of *certiorari*. See generally *American Tel. & Tel. Co. v. MCI Communications Corp.*, 748 F.2d 799 (7th Cir. 1984) (appeal from evidentiary ruling prior to retrial denied).

¹²¹ BellSouth at 31; NYNEX at 10; Pacific Companies at 10; SWBT at 18; COMSAT at 17.

¹²² *Litigation Costs Decision*, 939 F.2d at 1047.

favor of allowing recovery of the avoided costs of litigation of post-judgment settlements in ratemaking is consistent with this treatment of defense costs. As a result, recovery of the costs of defending litigation should not weigh heavily in the carrier's analysis of the pros and cons of settling a case and should not offer adversaries any special leverage against a carrier. Avoiding the impact of the accounting and ratemaking treatment of an adverse judgment is likely to have a stronger influence on a carrier's settlement decisions, because the cost of an adverse judgment will not be presumptively recoverable through rates.¹²³ Refusal to create a presumption that ratemaking should treat the value of a settlement up to the avoidable costs of litigation as an allowable expense may detract somewhat from the carrier's incentive to settle,¹²⁴ but this will not be the only or even a primary consideration, according to some commenters.¹²⁵ By refusing to permit ratemaking recognition of antitrust settlements, except for the portion that represents the avoidable costs of litigation, we are not burdening ratepayers with settlements and will not create an incentive to use post-judgment settlements as a way to avoid the consequences of an adverse final judgment. We find that this is a better balance of the ratepayers' and carriers' interests in just and reasonable rates than our *NPRM* proposal, because the fact of carrier misconduct has not been finally resolved. This result also responds to both the court's concern in *Litton Accounting Appeal* that carriers defend themselves and to the court's questions in *Litigation Costs Decision* about the reasonableness of incentives created by the Commission's previous pre- and post-judgment distinction.

41. Settlements entered into after an adjudication of liability for an antitrust violation has become final by the termination of all appeals cannot be recovered in the ratemaking process, even if litigation over damages continues. This applies even to the avoided costs of litigation. Once the fact of the violation has been conclusively established, ratepayers should not be asked to pay for the consequences, even in part and even if the carrier is able to negotiate a settlement on more favorable terms than the verdict. Absent a showing of ratepayer benefit from the adjudicated misconduct, the carrier should be responsible for its misconduct. We recognize that this accounting treatment might encourage post-judgment settlements before the appeal process becomes final, but this incentive is no different than the incentive to settle created by our treatment of final adverse judgments.

42. The Pacific Companies argue that the Commission should broaden the definition of the avoidable costs of litigation "to recognize the fact that a settlement avoids the hazards of

¹²³ See NYNEX at 9. According to BellSouth, however, the entry of an adverse judgment is simply one factor a carrier must evaluate. It "must still weigh the costs of continuing the litigation against the probability of success on appeal." BellSouth at 30.

¹²⁴ BellSouth at 30, 31.

¹²⁵ NYNEX at 8 (settlement "is merely an economic decision."); Pacific Companies at 7-8 (listing factors and acknowledging that including settlement costs in operating accounts "will certainly not be the primary consideration in management's decision to settle or to defend a case."); COMSAT at 14; USTA at 24 ("settlements themselves are prudently made, but not because of nuisance value considerations.").

litigation, conserves scarce employee resources (e.g. the time of both legal and non-legal employees to continue to litigate), and saved lost opportunity and other hidden costs."¹²⁶ We disagree, for there would be no realistic limit to the amount of a settlement that would be recognizable in the ratemaking process with so broad and imprecise a definition. In *Alascom*,¹²⁷ the only case for which the Commission scrutinized an antitrust settlement under its previous litigation cost rules, only the documented estimates of costs saved as a direct result of the settlement were presumptively recoverable. The Commission denied recovery of costs that would have been incurred without regard to the litigation, such as the salaries of employees already on the payroll or employee opportunity costs, because no additional payment of money would have been required to support the litigation.¹²⁸ The Commission also denied recovery under the ratepayer benefit test of costs incurred as a result of deferred investment, because business decisions regarding capital investment are ongoing for any carrier facing litigation, imposing these costs under the guise of settlement recovery would render the litigation costs policy meaningless, and the alleged saved costs were too speculative.¹²⁹ The definition of the avoidable costs of litigation proposed by the Pacific Companies suffers from these same flaws. We continue to believe that the direct result test, which allows recovery of only the documented estimates of costs saved as a direct result of the settlement, is the appropriate test for the recovery of the avoidable costs of litigation, because it is tied to estimates that can be attributed directly to the costs of the litigation at issue and reasonably quantified. Furthermore, using a direct result test will discourage the recovery of excessive costs.

43. When the Commission previously allowed recovery for pre-judgment settlements, it stated that a pre-judgment settlement would be "presumptively recoverable from ratepayers" to the extent of "the additional litigation expenses ... which the carrier reasonably estimates it would have paid if it had not settled and which the carrier would have allocated to the interstate jurisdiction."¹³⁰ This was the standard for the avoidable costs of litigation established upon reconsideration in that proceeding. The court confirmed that the Commission acted within its authority in allowing carriers to recover, for ratemaking purposes, the portion of the settlement of an antitrust lawsuit that represents its "nuisance value," otherwise known as the avoided costs of litigation. Pointing to the *Alascom* proceeding, U S West argues that the administrative burden required on the parts of the Commission and the carriers in identifying the avoided costs of

¹²⁶ Pacific Companies at 9. In contrast, BellSouth and NYNEX refer to nuisance value as saved litigation costs. BellSouth at 30 (recovery of incremental litigation costs and counsel fees avoided by settlement is consistent with congressional policy in Alternate Dispute Resolution Act); NYNEX at 9-10.

¹²⁷ *Alascom, Inc., Request for Ratemaking Recognition of an Antitrust Settlement*, 5 FCC Rcd 654 (Common Car. Bur. 1990) (*Alascom*), modified, 6 FCC Rcd 3636 (1991) (*Alascom Recon. Order*).

¹²⁸ In contrast, costs associated with replacing in-house counsel during the antitrust trial were recoverable where credibly supported. *Alascom Recon. Order*, 6 FCC Rcd at 3638-39, ¶ 21.

¹²⁹ *Id.* at 3640-41, ¶ 36.

¹³⁰ *Reconsideration Order*, 4 FCC Rcd 4092, 4097 (1989).